Indiana Law Journal

Volume 27 | Issue 2 Article 5

Winter 1952

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STOCKHOLDERS' DERIVATIVE SUITS: A FEDERAL QUESTION?

It has been suggested by Mr. Justice Jackson that without the shareholders' derivative action there would be little practical check on the derelictions of corporate management.[1] Although far from adequate, this is the only available judicial remedy[2] for the protection of the rights of minority[3] stockholders; and more important, the only effective method of deterring would-be malefactors. The task of reconciling the rights of investors with the broad scope of managerial discretion asserted by corporate directors has vexed courts and legislatures alike in their efforts to circumscribe the proper limits of derivative actions.

Corporate indignation over the widespread resort to derivative suits for extortionate purposes has been a persistent factor promoting legislative and judicial limitations which have, in many cases, reduced the remedy to near impotence. The past decade produced frequent criticisms of this impairment of one of the few remaining means of assuring management responsibility; yet, of the numerous remedial proposals, none has achieved a satisfactory solution. Growth in the size of corporations, separation of ownership and control, and failure of the states adequately to cope with ensuing maladjustments render the inability of stockholders to protect their interests from abuses of corporation management a matter of national importance. Since there is scant likelihood that the states can be induced to act in unison to render the remedy a more effective one, Congress[4] is the only instrumentality capable of instituting the needed comprehensive reform. The recent equivocal legislative innovation embodied in Section 301 of the Taft-Hartley Act[5] suggests, as yet unexplored, perspectives in federal jurisdiction which may

1. Cohen v. Beneficial Industrial Loan Corp., 337 U.S. 541, 548 (1949).

2. The SEC may institute actions under the Securities Exchange Act of 1934, 48 STAT. 896, 15 U.S.C. § 78p(b) (1946), and the Investment Companies Act of 1935, 50 STAT. 826, 15 U.S.C. § 80a-25(c) (1946). The pressure of public opinion may in itself dissuade directors from wrongful acts. Many states have imposed civil and even criminal sanctions against certain forms of mismanagement. *E.g.*, IND. STAT. ANN. §§ 25-251, 25-252 (Burns Repl. 1948).

3. Derivative suits have been employed by stockholders of wholly owned corporations to prevent malfeasance by those whom they have placed in power. See Randall v. Dudley, 111 Mich. 437, 69 N.W. 729 (1897); Button v. Hoffman, 61 Wis. 20, 20 N.W. 667 (1884).

4. See Hornstein, *The Future Of Corporate Control*, 63 HARV. L. REV. 476, 481 (1950), suggesting that relief might be made available through Congress by authorizing suits in the federal courts by stockholders of corporations whose securities had been sold in interstate commerce. Recommended, as an alternative, is the formation of an administrative agency to investigate and punish cases of corporate mismanagement.

5. 29 U.S.C. § 185 (Supp. 1951).

offer a new approach to the shareholder's dilemma. Remedial legislation may assume either of the following forms: (1) creation of a federal forum in which stockholders' derivative suits may be initiated without diversity of citizenship; (2) establishment of substantive standards of conduct for directors and definition of shareholders' rights, either explicitly detailed by Congress or reserved for judicial delineation.

A cursory examination of the numerous attempts to limit derivative actions will reveal the success achieved in enabling directors to subordinate investors' interests without fear of accountability. Since 1944, when New York enacted its "security for expenses" statute,[6] such suits have become practically extinct[7] in this and other states adopting similar restrictive legislation.[8] The Supreme Court has indicated that these pro-

6. The New York Security for Expenses Act, provides: "In an action instituted or maintained in the right of any foreign or domestic corporation by the holder or holders of less than five per centum of the outstanding shares of any class of such corporation's stock or voting trust certificates, unless the share . . . have a market value in excess of fifty thousand dollars, the corporation in whose right such action is brought shall be entitled . . . to require the plaintiff or plaintiffs to give security for the reasonable expenses, including attorney's fees, which may be incurred by it in connection with such action . . . to which the corporation shall have recourse in such amount as the court having jurisdiction shall determine upon the termination of such action. The amount of the security may thereafter from time to time be increased or decreased in the discretion of the court having jurisdiction. . . ." N.Y. GEN. CORP. LAW § 61-b.

7. In the two and one-half years following the adoption of the New York "security for expenses" statute only four shareholders' actions involving widely-held corporations were instituted in the Superior Court of New York county, as compared with an annual average of over fifty a year in the preceding decade. The N. Y. STATE CHAMBER OF COMMERCE SURVEY AND REPORT REGARDING STOCKHOLDERS' DERIVATIVE SUITS 3 (1944). For other examples of decreasing use of these actions see Hornstein, *New-Aspects of Stockholders' Derivative Suits,* 47 COL. L. REV. 1 (1947); Hornstein, *The Future of Corporate Control,* 63 HARV. L. REV. 476 (1950).

8. N.Y. GEN. CORP. LAW § 61-b; N. J. STAT. ANN. §§ 14:3-15 (Cum. Supp. 1948); PA. STAT. ANN. tit. 12, § 1322 (Purdon, 1945). To the same effect, but excluding attorney's fees from the expenses for which security must be given, see MD. ANN. CODE GEN. LAWS art. 16, § 195 (Cum. Supp. 1947). The Wisconsin statute provides that no derivative suit shall be maintained against directors or officers of a Wisconsin corporation by holders of less than five per cent of "any" class, "unless the action is one based on conduct which results, and is willfully intended to result, in direct or indirect personal benefit or advantage to one or more directors or officers, or conduct which results in a personal benefit or advantage to one or more stockholders over the other stockholders." WIS. STAT. § 180.13 (1947). This unique statute is criticized in Note, [1948] WIS. L. REV. 580. The California act eliminates some of the inferior features of the New York type statute and provides for a preliminary inquiry to determine whether maintenance of the suit is likely to be advantageous or detrimental to the corporation. The court then establishes the nature and amount of security to be furnished by the plaintiff for litigation expenses. Cal. Stat. 1949, c. 499. For a thorough discussion of the California statute see Ballentine, *Abuses of Shareholders Derivative Suits: How Far Is California's New 'Security For Expenses' Act Sound Regulation,* 37 CALIF. L. REV. 399 (1949). See generally Hornstein, *New Aspects of Stockholders' Derivative Suits,* 47 COL. L. REV. 1 (1947); Hornstein, *Death Knell of Stockholders' Derivative Suits in New York,* 32 CALIF. L. REV. 123 (1944); Bowes, *Should New York's Security For Expenses Act Be Amended,* 2 SYRACUSE L. REV. 37 (1950).

visions are of such consequence that they must be applied by the federal courts in diversity cases.[9] New York legislation, calculated to undermine shareholders' remedies, was sponsored by an organization fronting for conservative corporation and financial interests.[10] The same group[11] has urged outright abandonment of derivative actions.[12]

A further obstacle to such actions is the prerequisite that the plaintiff must have been a shareholder at the time of the questioned transaction or have acquired his stock thereafter by operation of law.[13] While most jurisdictions permit suits by equitable owners, at least one state has provided that the plaintiff must be a registered holder.[14] Frequently, the shareholder's right to assert the corporate cause of action will have vanished prior to his discovery of the malfeasance, as a result of the company's failure to prosecute, or suppression of facts indicative of misconduct, until the period of limitations has expired. The harshness of this result is intensified by legislative catering to corporate interests through reduction of the statutory period.[15]

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9. In Cohen v. Beneficial Industrial Loan Corp., 337 U.S. 541 (1949), the Supreme Court held the New Jersey "Security for Expenses" statute constitutional. Further, it was held to be not merely procedural and, hence, applicable in the federal courts under the *Erie* doctrine.

10. "The N.Y. State Chamber of Commerce, to which you credit this action is not in fact a state chamber of commerce. It is strictly a New York [city] organization composed very largely of the extremely conservative corporation and financial interests of that city." Communication from the Springfield (Ill.) Chamber of Commerce to the Editor, Forbes Magazine, May 15, 1944, p. 10. See Hornstein, *New Aspects of Stockholders' Derivative Suits*, 47 COL. L. REV. 1 (1947).

11. Brief of N.Y. State Chamber of Commerce as *amicus curiae*, p. 25, Shielcrawt v. Moffett, 294 N.Y. 180, 61 N.E.2d 435 (1945), discussed in Hornstein, *New Aspects of Stockholders' Derivative Suits*, 47 COL. L. REV. 1 (1947).

12. In advocating elimination of these suits, such groups may unwittingly be acting to their own detriment; if the derivative suit and hence, most of the protection for the corporate investor should be eliminated, the desire to invest may also disappear. This, of course, would have no immediate effect on the investing public; it might, however, have some future influence on the ability of certain corporations to obtain share capital. Local, unlisted concerns might be forced to look other than to the general public for capital sources.

13. N.Y. GEN. CORP. LAW § 61; FED. R. CIV. P. 23(b)(1). It is still undetermined whether 23(b) is substantive or procedural, and hence whether it would be applied in federal diversity suits. For a complete discussion of 23(b), see 3 MOORE'S FEDERAL PRACTICE ¶ 23.01(3) (2d ed. 1948).

14. Cal. Stat. 1949, c. 499, Corp. Code § 834(a)(1). While, generally the California statute is less harsh than most "security for expenses" acts, in providing that the plaintiff must be a "registered shareholder", it has introduced a disqualification going beyond other restrictive legislation. In most jurisdictions it is sufficient that the plaintiff be an equitable shareholder or unregistered owner.

15. Until 1937 the prevailing belief was that New York stockholders' suits, being in equity, were subject only to the ten year period of limitations with a possible extension if actual fraud were the basis and were undiscovered within the original period. In 1937, however, the Court of Appeals in Potter v. Walker, 276 N.Y. 15, 11 N.E.2d 335 (1937), held that under certain circumstances the applicable period was ten years, and in other instances only six. After conflicting applications of the new rule in the lower

A Massachusetts decision[16] suggests a further contrivance to defeat the rights of minority shareholders. In that case the right to sue was subjected to defeasance by majority vote. While the court required that the disqualifying majority be an independent, disinterested one, acting reasonably and in good faith, nonetheless, such a decision seems to invite collusion between majority shareholders and erring directors.[17] The proffered justification for requiring the plaintiff to seek redress through a stockholders' meeting is to encourage internal settlement of corporate problems. This reason actually obtains in relatively few cases. The complexity of the question, practical difficulty of securing presence of a majority, and expense and delay entailed, all suggest that such an appeal is an inconvenient and unwarranted qualification of the plaintiff's prerogative.

Perhaps the greatest impediment to the bringing of derivative suits is the difficulty of obtaining jurisdiction in a state court over defaulting directors. Membership on the directorate of the large corporation is dispersed throughout the United States, with attendant infrequency of meetings and delegation to executive committees. Yet, such absentee directors cannot so facilely transfer responsibility for conduct of the company's affairs. Hence, they are necessary parties defendant in a shareholder's suit against corporate management, with the result that service of process is an insuperable barrier to challenging aberrations of the board of directors in state courts. The defender of investors' interests, thus, may turn to the federal courts where he is confronted at the threshold not only with an identical service of process obstacle, but in addition,

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courts, the New York Law Revision Commission, in 1942, recommended statutory clarification.

Instead of alleviating the situation, the Legislature reduced the period from "ten and six" to "six and three" years respectively, although not a single witness at the hearing on the legislation publicly recommended this reduction. *Minutes of Public Hearing Before the Joint Legislative Committee on the Judiciary,* Feb. 18, 1942. The period is now six years if the action is for an accounting or if based on fraud. Presumably the statute runs from the date of the fraud and *not* its discovery, and three years if the action is "for waste or for an injury to property or for an accounting in connection therewith." N.Y. CIV. PRAC. ACT, § 48, subd. 8; *Id.* § 49 subd. 7. See Hornstein, *New Aspects of Stockholders' Derivative Suits,* 47 COL. L. REV. 1, 5 (1947); House, *Early Exoneration for Delinquent Directors In New York,* 46 COL. L. REV. 377 (1946).

16. S. Solomont & Sons Trust Inc. v. New England Theatres Operating Corp., 93 N.E.2d 341 (Mass. 1950), noted in 49 MICH. L. REV. 898 (1950); 35 MINN. L. REV. 407 (1950); 39 CALIF. L. REV. 268 (1951).

17. The court's conclusion in the *Solomont* case is unique. It is a decision which, if followed without careful scrutiny of the facts (as to who composes the "independent disinterested majority" and whether they were acting "reasonably and in good faith") may lead to complete annihilation of minority suits.

with the necessity of establishing the requisite diversity.[18] Since the corporate defendant is considered an indispensable party[19] and frequently is domiciled in the same jurisdiction as the plaintiff, complete diversity[20] often is lacking.[21]

While diversity of citizenship and service of process are still *sine qua non,* realignment of parties, once a critical problem, is no longer of major significance; most federal courts have refused to realign, when to do so would defeat their jurisdiction.[22] Likewise, venue and *forum non conveniens,* once formidable barriers, have been greatly diminished by the Revision Act of 1948.[23] An action no longer need be dismissed for improper venue or an inconvenient forum, provided there is a district

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18. 62 STAT. 930 (1948), 28 U.S.C. § 1332 (Supp. 1951) provides that "The district courts shall have original jurisdiction of all civil actions where the matter in controversy exceeds the sum of $3,000 exclusive of interest and costs, and is between: (1) Citizens of different States. . . ."

19. Parties have been classified as formal, necessary, and indispensable. The classification is important in determining what parties *may* or *must* be present in a particular case and, especially in federal courts, in deciding questions of jurisdiction and venue. The classic American statement of the rule as to indispensability was made in Shields v. Barrow, 17 How. 130 (U.S. 1854): "Persons [are indispensable] who not only have an interest in the controversy, but an interest of such a nature that a final decree cannot be made without either affecting that interest, or leaving the controversy in such condition that its final determination may be wholly inconsistent with equity and good conscience." See generally, 3 MOORE'S FEDERAL PRACTICE ¶ 19.02 (2d ed. 1948).

20. Diverse citizenship as a basis for federal jurisdiction must exist between all plaintiffs on one hand and all defendants on the other when suit is instituted. Osthaus v. Button, 70 F.2d 392 (3d Cir. 1947); Lavering & Garrigues Co. v. Morrin, 61 F.2d (2d Cir. 1932), *aff'd,* 289 U.S. 103 (1933); Strawbridge v. Curtis, 3 Cranch 267 (U.S. 1806).

21. An early technique of insuring federal jurisdiction was to arrange for suit against the corporation by a nonresident stockholder, or to have shares transferred to a nonresident who would, upon formal refusal of the board of directors to act, bring an action in the federal court. This practice was properly condemned as an imposition upon federal jurisdiction. Hawes v. Oakland, 104 U.S. 450 (1882).

This led to adoption of Equity Rule 94 by the Supreme Court, which was designed to guard against any type of collusive suit. The rule later appeared as Federal Equity Rule 27, now Federal Rule 23(b). It is specifically limited to stockholder suits which are derivative in nature. Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947). Under Rule 23(b) the plaintiff-shareholder must allege under oath that (1) he was a stockholder at the time the transaction took place, or that his share has since devolved upon him by operation of law; and (2) the action is not a collusive one. The latter provision is a mere formality since the adoption of the "collusive" provision in the Revision Act of 1948, 28 U.S.C. § 1359 (Supp. 1951) which provides: "A district court shall not have jurisdiction of a civil action in which any party, by assignment or otherwise, has been improperly or collusively made or joined to invoke the jurisdiction of such court."

22. For a discussion and collection of cases, see 3 MOORE'S FEDERAL PRACTICE ¶ 23.21(1) (2d ed. 1948).

23. 62 STAT. 935 (1948), 28 U.S.C. § 1359 (Supp. 1951).

or division in which suit could have been properly initiated. In this case the action is transferred where timely objection is made.[24]

Proposals to alleviate the hardships consequent upon the increasing ineffectiveness of the derivative action have been numerous, *albeit* productive of little improvement. Solutions advocated range from measures entailing only slight modification by individual states of their existing regulations to complete nationalization of the corporate enterprise. For example, one writer[25] recommends an integration of the more desirable features embodied in the derivative action provisions of several jurisdictions. This plan would comprehend elimination of private settlements;[26] enactment of the California "security for expenses" statute providing for preliminary hearing on the necessity of depositing security, rather than the New York arbitrary per cent or dollar requirement; and codification of the New York Court of Appeals' decision in *Clarke v. Greenberg,*[27] which held that the plaintiff's recovery is received in a fiduciary capacity for the benefit of the corporation. While commendably attempting to eliminate strike suits without also sterilizing the remedy, this arrangement presupposes the impossible—unanimity of state corrective endeavors.[28]

Illustrative of the more far-reaching methods of projected corporate reform are the recurrent O'Mahoney federal incorporation bills[29] and a scheme for obtaining "responsible capitalism" through creation of a national management group, responsive to the public will, to supervise affairs of the country's 200 foremost concerns.[30] Senator O'Mahoney's

24. See 63 STAT. 101, 28 U.S.C. § 1406 (Supp. 1951), recognizing that improper venue may be waived. See also, 62 STAT. 937, 28 U.S.C. § 1404(a) (Supp. 1951), permitting transfer to a more convenient district or division that is proper.

25. BOWES, *Should New York's Security For Expenses Act Be Amended,* 2 SYRACUSE L. REV. 37, 52 (1950).

26. Rule 23(c) of the Federal Rules of Civil Procedure stipulates that, "A class action shall not be dismissed or compromised without approval of the court. . . ."

27. 226 N.Y. 146, 71 N.E.2d 443 (1947).

28. To be effective state remedies must be uniform in their elimination of restrictive rules now existing in the various jurisdictions. The very states in which most corporations are organized have been most lax in adopting measures for corporate reform. The reason, of course, is the increased revenue attendant upon the entry of new corporations.

29. In August, 1936, Senator O'Mahoney suggested his first corporate licensing bill, and in January, 1937 introduced his now famous SEN. 10, 75th Cong., 1st Sess. (1937). This bill was designed to regulate interstate and foreign commerce by prescribing the conditions under which corporations may engage or may be formed to engage in such commerce. In 1949, after inactivity during the war years, he introduced a bill providing "for the issuance of certificates of statutory compliance with certain national standards to certain corporations, trade associations, and labor organizations engaged in or affecting commerce." SEN. 10, 81st Cong., 1st Sess. (1949). For a complete history of the O'Mahoney proposals and other views on federal incorporation, see REUSCHLEIN, SCHOOLS OF CORPORATE REFORM (1950).

30. The 200 would no longer be regarded as private business, but as public institutions. Their management would not be responsible to the stockholders alone, but

persistence appears fruitless. Emphasizing the improbability of adoption of the second plan is the author's concession that its success depends on a thoroughgoing reorganization of the administrative branch.[31]

The strength of federal proposals for needed redress or deterrence of corporate abuse lies in their proponents' recognition that adequate relief cannot be secured on a piece-meal basis. Their weakness is attributable to universal failure, prior to enactment of Section 301, to perceive the possibility of purely non-substantive federal measures. Section 301 of the Taft-Hartley Act[32] provides that suits may be instituted in the federal district courts, without regard to diversity or the amount in controversy, by employers or labor unions. This provision fails to create, specifically, any substantive rights. It is undetermined[33] whether state law is to be applied to suits in the federal courts for breach of collective bargaining agreements, or whether the federal tribunals are

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to all the people. The objective would be a smoothly running economy. Mr. Fischer points out that such a concept need not involve public ownership; that on the contrary, its aim would be to avoid wholesale nationalization. Fischer, *The Lost Liberals,* 194 HARPERS 385 (1947).

31. There have been suggested numerous other proposals, both to strengthen derivative actions and to abolish them in favor of substitutes. *E.g.,* In Douglas, *Directors Who Do Not Direct,* 47 HARV. L. REV. 1305 (1934), the author advocates that private agencies be established to prosecute and investigate charges of the complaining shareholders. Similarly, public agencies might be used for the same purpose along with further utilization of the administrative process. Berlack, *Stockholders Suits: A Possible Substitute,* 35 MICH. L. REV. 597 (1937). In Pound, *Visitatorial Jurisdiction Over Corporations in Equity,* 49 HARV. L. REV. 369, 395 (1936), it is contemplated that the derivative suit could be supplanted by more frequent application of the visitatorial powers of equity through information by the attorney general. It has also been suggested that more frequent use of the "death sentence" found in judicial winding up proceedings might be possible. Hornstein, *A Remedy For Corporate Abuse—Judicial Power to Wind Up A Corporation At The Suit of A Minority Stockholder,* 40 COL. L. REV. 220 (1940). In Washington, *Stockholders' Derivative Suits: The Company's Role, and A Suggestion,* 25 CORNELL L.Q. 361 (1940), the author states that a "judicial department" might be created within the corporation, including perhaps a lawyer, an accountant and one of the directors, all chosen by the stockholders. A further proposal would employ a federal administrative agency as a possible forum for the redress of wrongs against stockholders—the ICC or SEC could be given quasi-judicial functions to pass on claims of mismanagement. Hornstein, *A New Forum For Stockholders,* 45 COL. L. REV. 35 (1945). Yet another suggestion would empower a federal agency endowed with investigatory authority to license corporations. Those not licensed would continue to use the equitable remedy; those that were would first be required to appeal to the agency. Stocker, *The Derivative Suit: Its Limitations and A Suggestion,* 29 GEO. L.J. 363 (1940).

32. 29 U.S.C. § 185(a) (Supp. 1951) provides: "Suits for violations of contracts between an employer and a labor organization representing employees in an industry affecting commerce . . . or between any such labor organizations may be brought in any district court of the United States having jurisdiction of the parties, without respect to the amount in controversy or without regard to the citizenship of the parties."

Section (b) stipulates that any such labor organization shall be bound by the acts of its agents, and may sue or be sued as an entity.

33. The question of the construction of Section 301 has not been settled by the Supreme Court.

to devise their own substantive principles. If Congress intended only to remedy a jurisdictional or procedural defect arising from the fact that in some states a labor union could not sue or be sued, then perhaps a state cause of action is involved and the Act merely furnished a federal forum. Several decisions have attributed this purpose to Section 301.[34] If this construction is endorsed by the Supreme Court, the power of Congress to superimpose uniform procedures upon state substantive regulatory measures by providing that they be enforced by the federal judiciary will be established.[35]

This innovation suggested by Section 301 would permit deference to the state's prerogative to regulate corporations, an area in which it has traditionally been unchallenged,[36] and yet dispose of numerous impediments to the shareholder's suit. Creation of a national forum for derivative actions would enable the shareholder to sue in the federal courts regardless of diversity. The process dilemma could be avoided by instituting nation-wide service.[37] Thus, when a dissatisfied investor feels that gross negligence or fraudulent conduct of directors is subverting the company's interests, a ready means is presented of circumventing procedural pitfalls to a stockholder's suit.

Section 301, viewed as a jurisdictional matter, presents constitutional issues identical to those inherent in the creation of a forum in which to bring shareholders' derivative actions. In either case the logical constitutional basis for such a broad grant of jurisdiction is the *arising under* provision of Article III, Section 2, which indicates the

34. In Amazon Cotton Mill Co. v. Textile Workers of America, 167 F.2d 183, (4th Cir. 1948), it was held that the provision permitting suits in federal courts by or against labor organizations as entities was designed to emphasize their capacity to enter or be brought into courts as parties, and not to enlarge the class of cases of which district courts were given jurisdiction. While in Bonner Mfg. Co. v. United Furniture Workers of America, 90 F. Supp. 723 (S.D. N.Y. 1950), the court in comparing section 301 with section 303 (the latter section specifically including substantive provisions) indicates that 301 merely creates a forum. It was necessary in 301 to expressly eliminate the diversity requirement in an action under that section, while it was not necessary to do so in 303 since it includes substantive rights. The case of Boeing Airplane Co. v. Aeronautical Ind. Dist. Lodge, 91 F. Supp. 596 (Wash. 1950), *aff'd*, 188 F.2d 356 (9th Cir. 1951), involved the question whether there had been a recision, by the plaintiff, of the collective-bargaining agreement existing between the plaintiff-employer and defendant-union. The court held, applying the *Erie* rule, that under the law of the state there was a recision by the plaintiff precluding a suit for damages.

35. It seems likely that prior to this time, this had never been done. Section 301 is unique in its *complete* omission of federal substantive provisions.

36. Such a proposal undoubtedly would be more politically expedient.

37. FED. R. CIV. P., 4(f) permits nation-wide service of process if the federal statute involved so provides. See, *e.g.*, the Federal Interpleader Act, 63 STAT. 105 (1948), 28 U.S.C. § 2361 (1950).

source and perhaps[38] limitations of jurisdiction which Congress may confer on the federal courts. The question is thus a novel one of constitutional authority—whether the section is sufficiently broad to sanction a statute which merely grants jurisdiction. It has been asserted that Section 301, under this construction, is unconstitutional because: "Back of all such grants [statutes conferring federal question jurisdiction] must lie a cause of action in federal law: *to wit* a statute creating substantive rights which may be asserted in the federal court. Thus, in the *Osborn* case, the omnipresent bank charter imbued all the Bank's transactions with a federal nature."[39] Under such an interpretation of *Osborn,*[40] that case held the Constitutional verbiage, "arising under the laws of the United States," to mean *arising under* only those laws creating federal substantive rights.[41]

In other writings discussing the meaning to be accorded to *arising under* the controversy has centered around the identical statutory language in the Act of 1875.[42] Essentially, the disagreement concerns the necessity of a substantial controversy or real dispute involving the federal law in question. Beginning in 1877 with *Gold-Washing & Water Co. v. Keyes,*[43] the courts have consistently held that a suit does not arise under federal law within the meaning of the statutory jurisdictional grant unless it is precipitated by a controversy between the parties concerning the effect of the federal act upon the facts involved. Justice Cardozo's language in *Gully v. First National Bank*[44] is the focal point of the argument: "A suit to enforce a right which takes its origin in the laws of the United States is not necessarily, or for that reason alone, one *arising under* those laws, for a suit does not so arise unless it really and substantially involves a dispute or controversy respecting the validity, construction or effect of such a law, upon the determination of which the result depends." Professor Forrester has insisted that, in the light of *Gully* and *Osborn,* the statutory *arising under* should be interpreted as

38. The conflict in the Supreme Court in National Mutual Insurance Co. v. Tidewater Transfer Co., 337 U.S. 582 (1949), was whether Article III, section 2 of the Constitution was controlling as to the types of "cases and controversies" enumerated therein, and hence whether it was a limiting section. See note 54 *infra.*

39. Note, *Section 301(A) Of The Taft-Hartley Act: A Constitutional Problem Of Federal Jurisdiction,* 57 YALE L.J. 630 (1948). The writer recognizes, however, that Section 301 may constitutionally be upheld as a statute intended to include substantive rights, such being enunciated by the federal courts.

40. Osborn v. Bank of the United States, 9 Wheat. 264 (U.S. 1821).

41. The *Osborn* decision was prior to any legislative enactment incorporating the "arising under" phrase, and was therefore only interpretative of the constitution.

42. Presently 36 STAT. 1091, 28 U.S.C. § 41(1) (1940).

43. 96 U.S. 199 (1877).

44. 299 U.S. 109 (1936).

broadly as its constitutional counterpart,[45] which, he contended, does not require a "real dispute" concerning the federal law. However, in a later commentary,[46] the same author apparently recedes from this view and intimates that only the constitutional *arising under* is to be accorded the broader construction.

From the *Gully* language it can be inferred that the Supreme Court's interpretation of the constitutional *arising under* is more narrow than that which Professor Forrester imputed to the *Osborn* decision.[47] Messrs. Chadburn and Levin evidently concur in Cardozo's view equating the constitutional *arising under* with the *real dispute* theory.[48] The basic differences in point of view revealed by the comments on *arising under* herein discussed are illustrative of the writings on this aspect of federal jurisdiction. However, they fail to advance the present inquiry into the constitutionality of a Congressional attempt to invoke federal question jurisdiction in the absence of a federal law creating substantive rights. This question is an entirely unprecedented one which manifestly should not be governed by gratuitous language in existing cases construing *arising under* in an entirely different context.[49] Nothing short of mechanical jurisprudence could justify reliance on the *Gold-Washing —Gully* line of authority to defeat achievement of a legitimate national aim which Congress seeks to accomplish by means of such a grant of

45. Forrester, *Federal Question Jurisdiction And Section 5,* 18 TULANE L. REV. 263, 288 (1943): "If . . . it is felt that such words give the federal courts jurisdiction over more cases than they can properly handle, the solution is not to be found in misreading the law, as was done . . . recently in the *Gully* case, but in passing a new statute with words that actually do limit the amount of federal question jurisdiction granted to the trial courts.

"Insofar as the clause in the Constitution is concerned, the generous rule of the *Osborn* case, although in need of restatement for clarity, should be retained. The constitutional source of judicial power should be broad in order to take care of the unknown and uncertain needs of the future."

46. Forrester, *The Jurisdiction of Federal Courts in Labor Disputes,* 13 LAW & CONTEMP. PROB. 114 (1948).

47. Both Prof. Forrester and Messrs. Chadburn and Levin agree that this may be implied from the *Gully* decision. Forrester, *The Nature Of A Federal Question,* 16 TULANE L. REV. 362, 370 (1942); Chadburn & Levin, *Original Jurisdiction Of Federal Questions,* 90 U. OF PA. L. REV. 639, 651 (1942).

48. It must be remembered that the "arising under" decisions have always been interpretative of federal statutes embracing substantive rights.

49. It is a familiar principle that the statutory meaning of a term may be more restricted than its constitutional interpretation. Towne v. Eisner, 245 U.S. 418, 425 (1918); Lamar v. United States, 240 U.S. 60, 65 (1916). See also Treines v. Sunshine Mining Co., 308 U.S. 66 (1939), where the possibility of different statutory and constitutional meanings are discussed; and Note, 32 MINN. L. REV. 818 (1948). Indeed, Mr. Justice Rutledge has pointed out that the mere identity of words in the Constitution and in the statutes purporting to effectuate constitutional powers is no guarantee that constitutional and statutory words mean—or indeed, were ever intended to mean—the same thing. National Mutual Insurance Co. v. Tidewater Transfer Co., 337 U.S. 582, 615 (1949).

jurisdiction. The only considerations relevant to the constitutional issues pertain to those fundamental policies, embodied in Article III, which underlie the permissible scope of federal jurisdiction.[50]

National Mutual Insurance Co. v. Tidewater Transfer Co.[51] makes tenable the view that creation of a federal forum might be upheld under Article I powers. There the court upheld the constitutionality of a statute treating the District of Columbia as a state for purposes of diversity. Justices Jackson, Burton and Black declined to overrule *Hepburn and Dundas v. Elizey*[52] which held that the District is not a state within the meaning of Article III. Instead, Article I power to legislate for the District was said to empower Congress to open the federal courts anywhere to its citizens. The remaining Justices, both concurring and dissenting, vigorously rejected the Article I rationale.[53] Acceptance of Justice Jackson's position would produce a radical modification in the traditional appraisal of Congress' power to impart jurisdiction to the district courts. He would place no further qualification upon permissible grants of jurisdiction than the restriction to "cases and controversies" and rejects any limitation to those particular types specifically enumerated in Article III.[54] While the Article I argument expounded in this case may not immediately gain the approval of those justices as yet uncommitted to this theory, it can not be discounted as a basis for upholding future

50. It has been suggested that the Constitution confers on the courts power to disregard prior cases where a question of constitutionality is involved. The Constitution embodies the conflicting ideals of the community and no one can authoritatively say what these ideals mean. The court should not be able to bind itself in such a matter, and there should always be available an appeal to the Constitution. Levi, *An Introduction To Legal Reasoning,* 15 U. OF CHI. L. REV. 501, 541 (1948). As Mr. Justice Frankfurter has observed, ". . . the ultimate touchstone of constitutionality is the Constitution itself and not what we have said about it. . . ." See Graves v. New York *ex rel.* O'Keefe, 306 U.S. 466, 487 (1939) (concurring opinion).

51. 337 U.S. 582 (1949).

52. 2 Cranch 445 (U.S. 1805). Chief Justice Marshall ruled that the general diversity jurisdiction conferred by the Judiciary Act of 1789 did not embrace citizens of the District of Columbia within the term "citizen of a state."

53. The concurring opinion of the late Mr. Justice Rutledge, for himself and Justice Murphy, took issue with the Article I argument and held the Act constitutional only after overruling Marshall's decision in the *Hepburn* case. The minority, in two dissents, one by Mr. Justice Frankfurter for himself and Justice Reed, and the other by the Chief Justice, concurred in by Mr. Justice Douglas, disagreed sharply with the Article I theory, but like Justices Jackson, Black and Burton, upheld the sanctity of the *Hepburn* opinion.

54. National Mutual Insurance Co. v. Tidewater Transfer Co., 337 U.S. 582, 590, 591 (1949). It is at this view that most of the objections of the Jackson opinion have been directed. See Comment, 48 MICH. L. REV. 999, 1005 (1950) in which it is pointed out, "The establishment of inferior tribunals under specific Article I power to create them has always been assumed to be subject to the limitations of Article III." See also, Note, *The Tidewater Case And Limited Jurisdiction of Federal "Constitutional" Courts,* 3 VAND. L. REV. 271, 273 (1950).

broad grants of jurisdiction where no single view is strong enough to gain support of an outright majority.[55]

Creation of a federal forum for the litigation of a state derivative action would enable a dissident shareholder to circumvent some of the procedural legerdemain formerly impeding recourse to legal remedies, yet patently falls short of removing all the defects with which such suits presently are encumbered. The latter is emphasized by the tendency of the courts to classify as substantive an increasing number of state law questions formerly regarded as procedural.[56] Hence, it would not be amiss to examine the possibility of including in this innovation a degree of federal substantive regulation of derivative actions.

Again the judicial fortunes of Section 301 of the Taft-Hartley Act are pertinent. While this provision fails to expressly enunciate standards, some courts have taken the position Congress intended to create a federal cause of action,[57] leaving to the judiciary the task of

55. A tribunal reluctant to countenance mere establishment of a federal forum, yet cognizant of the numerous weighty considerations supporting the Constitutionality of such a bestowal of federal question jurisdiction, perhaps might evade the apparent consequences of confirming the legislative action by resort to the procedure employed in Bell v. Hood, 327 U.S. 678 (1946). This was a civil action predicated solely on the Fourth and Fifth Amendments, in which the plaintiff sought to recover damages against an FBI agent for injuries allegedly sustained as a consequence of an illegal search and seizure. The Supreme Court decided the district court had jurisdiction to inquire whether there was a federal cause of action. On remand, the lower tribunal dismissed on the ground that the Amendments supplying the jurisdiction failed to include remedial provisions, 71 F. Supp. 813 (S.D. Cal. 1947). Congress could effectively prevent such evasive tactics by stipulating that state law has been adopted, and for the purposes of derivative actions shall be accorded the same treatment as federal legislation.

This in itself might be a sufficient peg on which to hang the constitutionality of such a proposal. An express provision that state law is to be applied could be construed as Congressional adoption of the state law, the federal statute then comprising the sole basis of the cause of action. Such an interpretation would, in effect, allow the federal statute to be treated as one including both procedural and substantive principles.

56. See note 9 *supra;* Ragan v. Merchants Transfer & Warehouse Co., 337 U.S. 530 (1949) (holding the Kansas Statute of Limitations applicable in a suit brought in the federal district court).

57. See Wilson & Co. v. United Packinghouse Workers of America, 83 F. Supp. 162 (S.D. N.Y. 1949). In Shirley-Herman Co. v. International Hod Carriers, 182 F.2d 806 (2d Cir. 1950), suit had been filed for damages resulting from a work stoppage induced by the defendant in violation of a provision in the collective bargaining agreement requiring arbitration previous to a cessation of work. It was held that the district court had jurisdiction under 301 and further that 301 created substantive remedies where none existed before. Under New York law, it was necessary for plaintiff to show bad faith and the defendant contended that this had to be shown in the federal court. But the right was said to create no requirement of bad faith, therefore, state law was not relevant. This case was followed in Fay v. American Cystoscope Makers, Inc., 98 F. Supp. 278 (S.D. N.Y. 1951), where 301 was held to create a new, federal substantive right. However, this court went one step further, declaring that Congress had clearly pre-empted the field in this area. Such a conclusion does not necessarily follow from the mere creation of substantive rights, as the court seemed to indicate. Rather

working out in detail a federal decisional law of collective bargaining agreements.[58] If these cases are correct, Congress has for the first time merely indicated an appropriate area of federal regulation, leaving entirely to the courts the function of implementing this policy through a case-by-case delineation of the governing criteria.[59] Federal regulation

than being exclusive, such rights properly would co-exist with state law in the absence of clear Congressional intention to the contrary or conflict with state rules.

The problem of pre-emption would also exist in creation of federal substantive rights for stockholders' derivative suits, See Hill v. Florida, 325 U.S. 538 (1945); Note, *Occupation of The Field In Commerce Clause Cases, 1936-1946; Ten Years of Federalism,* 60 HARV. L. REV. 262 (1946). In Amalgamated Ass'n v. Wisconsin Employment Relations Board, 340 U.S. 383 (1951), Mr. Justice Frankfurter, dissenting, stated: "It is clear from these decisions that the States are not precluded from enacting laws on labor relations merely because Congress has—to use the conventional phrase—entered the field. It is equally clear that the boundaries within which a state may act are determined by the terrain and not by abstract projection." *Id.* at 403.

A federal statute governing stockholders' derivative suits might properly be declared exclusive, since Congress has authority to attach that label to any law. For example, see United States Warehouse Act, 7 U.S.C. § 269 (1940), which provides that federal power over federal licensing in that area shall be exclusive. However, Congress has occasionally made specific provision that its pronouncements on a subject shall not foreclose state regulation. *E.g.,* Securities Act of 1933, 15 U.S.C. § 77r (1940); Securities Exchange Act of 1934, 15 U.S.C. § 77bb (1940).

58. Wallace, *The Contract Cause of Action Under The Taft-Hartley Act,* 16 BROOKLYN L. REV. 1, 16 (1949), suggests: ". ... it may be inferred that Congress intended to leave it to the courts to work out the nature and detail of the substantive right by developing a 'national law' or 'federal common law' of collective-bargaining agreements. This would be a more charitable interpretation than to assume either that the Congressional draftsmen did not understand the implications of what they did, or that they were inept." That substantive rights may have been intended is also recognized in, Note, *Section 301(A) Of The Taft-Hartley Act: A Constitutional Problem Of Federal Jurisdiction,* 57 YALE L.J. 629, 635 (1948); but compare Forrester, *The Jurisdiction Of Federal Courts in Labor Disputes,* 13 LAW & CONTEMP. PROB. 114 (1948), where the author apparently fails to detect any such design in the Congressional enactment of Section 301.

59. Justice Brandeis' statement in the *Erie* case that there is no federal common law must not be read out of context; that principle is applicable only in diversity cases. He conceded that local law was to apply *except* in federal question cases. Erie v. Tompkins, 304 U.S. 64, 78 (1937). There is, of course, a federal common law. On the same day that *Erie* was decided, Justice Brandeis also delivered the opinion of the Court in Hinderlider v. LaPlata River & Cherry Creek Ditch Company, 304 U.S. 92, 110 (1937), in which he stated that the apportionment of the water of an interstate stream is "a question of 'federal common law,' which neither the statutes nor the decisions of either State can be conclusive."

There are areas where it is necessary for federal courts to carve out federal common law because state law has no application. *E.g.* (1) *where an interest of the United States is involved;* United States v. Standard Oil of California, 332 U.S. 301 (1947), recognized a right in the United States to recover medical expenses incurred in caring for a soldier injured through the negligence of the defendant, although there existed previously no such cause of action; Clearfield Trust Co. v. U.S., 318 U.S. 363 (1943), held that the United States could recover payment made on a forged check—"In the absence of an applicable Act of Congress it is for the federal courts to fashion the governing rule of law according to their own standards." See also, Board of County Commissioners v. U.S., 308 U.S. 343 (1939) (right of the U.S. to recover interest on taxes illegally collected by local government from an Indian); Girard Trust Co. v. United States, 149 F.2d 872 (3d Cir. 1945) (right of U.S. as lessee of property);

of derivative actions might perhaps be cast in the image of Section 301, as construed in these cases. While little motivation, other than political expediency, can be perceived for enacting remedial measures in this form, if Congress is so inclined, an unequivocal indication that federal principles are to govern is essential. Otherwise the same confusion which enshrouds Section 301 would result. A less specious approach would require Congress to specifically evolve substantive rules governing conduct of corporate directors, providing remedies for breach of such duties. Either alternative is likely to incur the criticism of opponents of federal expansion as a usurpation of functions within the province of state regulation.[60]

One possible solution to the perplexities surrounding derivative actions entails combining certain aspects of each of the alternatives thus far discussed. Congress could provide a federal forum for shareholders' suits, thereby precluding existing procedural difficulties, while expressly indicating that state law is to apply, except in specified situations where certain rules have adversely affected investors. The instances in which state law could be supplanted by federal regulation might include statutes of limitations, security for expenses statutes, and majority shareholder defeasance of an investor's right to sue. By adoption of such a hybrid program, many obstacles to redress of flagrant impositions upon stockholders' interests might be averted without incurring the disapprobation usually accompanying federal intervention in matters regarded as peculiarly of local concern.

Eisenhart, *Federal Decisional Law Independent of State Common Law Since Erie v. Tompkins,* 9 GEO. WASH. L. REV. 465 (1941);

(2) *because of the sweep of a federal statute;* D'Oench, Duhme & Co. v. F.D.I.C., 315 U.S. 447 (1942), determined that liability on a note given a bank is a federal question under the Federal Reserve Act, when the bank is insured by the FDIC. In Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156 (1946), the court decided that whether a bondholder may be paid interest on interest after default is a federal question when presented in a bankruptcy case. See also, Holmberg v. Ambrecht, 327 U.S. 392 (1946) (liability of shareholders of joint stock land bank is not governed by state law); American Surety Co. v. Bethlehem National Bank, 314 U.S. 314 (1941) (effect of illegal pledge of assets of national bank is a federal question); Dietrick v. Greaney, 309 U.S. 190 (1940) (defense to a note given a national bank in contravention of policy of National Banking Act is question of federal law);

(3) *because Congress has occupied the field;* Sola Electric Co. v. Jefferson Electric Co., 317 U.S. 173 (1942), held that in the field of patents, federal policy is supreme and state rules do not govern estoppel of a license to challenge a patent's validity. In O'Brien v. Western Union, 113 F.2d 539 (1st Cir. 1940), the court declared that in an action against a telegraph company for libel, federal law governs because the telegraph companies are subject to extensive federal legislation.

60. These would be subject to the same objections leveled against such proposals as federal incorporation, federal licensing and Mr. Fischer's proposal for federal supervision of the "200." See notes 29 and 30 *supra.*

Another deficiency in the derivative action, even where readily accessible, is the lack of stringency in the sanctions imposed. If this device is to benefit any but the few investors financially able to prosecute such litigation, its chief value must be as a deterrent. Federal legislation may be the most appropriate instrumentality for transforming the derivative suit into an effective potential threat to instill greater responsibility in corporate management. In a case of serious corruption, Congress could empower a court of equity to remove the offending director;[61] double or treble damages might be assessed against directors and officers guilty of fraudulent misconduct.[62] In extreme cases, where the fraud has been so pervasive as to seriously impair the company's going concern value, the judicial power to wind up the corporation might be invoked by the shareholder.[63]

If shareholders must continue to place reliance in the derivative suit as their chief bulwark against mismanagement, this remedy must be greatly improved to render it adequate to the function it is designed to perform. Since the states have so manifestly failed to accomplish the needed adjustment between managerial discretion and responsibility, federal intervention is not only warranted but imperative. Perhaps the suggested compromise between states' rights and the national interests in the welfare of investors will render such intervention less repugnant.